

Message Text

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PAGE 01 CAIRO 17463 171948Z
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SUBJECT: NEW FOREIGN EXCHANGE REGULATIONS

REF: CAIRO 17013

SUMMARY. FOLLOWING MESSAGE PRESENTS A BRIEF ASSESSMENT OF
PROSPECTS FOR INCREASED CAPITAL MOVEMENTS TO AND FROM EGYPT
IN CONTEXT OF NEW FOREIGN EXCHANGE LAW. END SUMMARY.

1. GENERAL EXPERIENCE INDICATES THAT CAPITAL FLIGHT IS NOT
A PROBLEM IN DEVELOPING COUNTRIES (ASSUMING REASONABLE PO-
LITICAL STABILITY), IF (1) EXCHANGE RATE AT WHICH LOCAL CUR-
RENCY CAN BE CONVERTED IS "APPRROPRIATE", AND (2) PROFITABLE
OPPORTUNITIES EXIST FOR INVESTING LOCAL CURRENCY AND FOREIGN
EXCHANGE IN EITHER BUSINESS ACTIVITIES OR SAVINGS ACCOUNTS.
NEGATIVE EFFECT OF SOMEWHAT INAPPROPRIATE EXCHANGE RATE CAN
BE OFFSET BY RELATIVELY MORE PROFITABLE INVESTMENT OPPORTUNI-
TIES -- OR VICE VERSA.

2. IN EGYPT, OFFICIAL EXCHANGE RATE CLEARLY OVERVALUED
BY ANY STANDARDS. HOWEVER, CONVERSIONS OF LOCAL CUR-
RENCY TO FOREIGNEXCHANGE WILL PRESUMABLY NOT BE POSSIBLE
AT THIS RATE FOR PRIVATE TRANSACTIONS WHICH MIGHT BE
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PAGE 02 CAIRO 17463 171948Z

ASSOCIATED WITH CAPITAL FLIGHT. IF PRIVATE CONVERSIONS
WERE POSSIBLE AT THIS RATE, FLIGHT OF CAPITAL WOULD BE
ENORMOUS. RECENT DEVLUATION OF POUND IN PARALLEL MARKET
FROM .68/U.S.\$ TO .70 U.S.\$ WAS ACCOMPANIED BY MOVEMENT IN
BLACK MARKET RATE TO .71 - .73/US \$ FROM PREVIOUS LEVEL OF ABOUT
.75/US \$. THIS WOULD INDICATE THAT CURRENT PARALLEL RATE

PROBABLY NOT TOO BAD. HOWEVER, SOME FURTHER DEVLUTION WILL BE NECESSARY IF DOMESTIC INFLATION NOT SUBSTANTIALLY REDUCED. ON BALANCE, FREE CONVERSION AT CURRENT PARALLEL RATE WOULD PROBABLY MARGINALLY TEND TO ENCOURAGE RATHER THAN DISCOURAGE CAPITAL FLIGHT -- ALTHOUGH OTHER FACTORS COULD OFFSET THIS. IN PARTICULAR, IF GOE DOES INDEED ENCOURAGE (THROUGH BOTH WORD AND DEED) EXPANDED PRIVATE SECTOR BUSINESS ACTIVITY, FUNDS ABROAD MAY BE DRAWN BACK TO EGYPT. ALSO, IF INTEREST RATES ON TIME DEPOSITS WERE INCREASED ABOVE THEIR CURRENT LOW LEVELS, AS RECOMMENDED BY THE IMF, THIS TOO WOULD HELP OFFSET A SOMEWHAT OVERVALUED EXCHANGE RATE.

3. ON THE WHOLE, POSSIBLE CHANGES IN THE CURRENT SITUATION WOULD APPEAR TO HAVE THE POTENTIAL OF ATTRACTING FUNDS HELD ABROAD BACK TO EGYPT WITH THE CREATION OF FREER CONVERTIBILITY. HOWEVER, THE ACTUALITY OF THE PRESENT CIRCUMSTANCES IN THE ABSENCE OF THESE POSITIVE CHANGES HAS A CLEAR POTENTIAL FOR CAPITAL FLIGHT. OUR UNDERSTANDING OF REGULATIONS THAT WILL BE APPLICABLE INITIALLY, THOUGH, INDICATES THAT CONVERTIBILITY WILL NOT BE ALL THAT FREE. TOURISM AND COMMODITY EXPORT EARNINGS ARE EXCLUDED AND BANKS WILL BE ABLE TO BUY FX FROM INDIVIDUALS BUT NOT SELL THEM FX. ON THE OTHER HAND, INDIVIDUALS WILL BE ABLE TO EXCHANGE FOREIGN EXCHANGE AMONG THEMSELVES AND, AS LONG AS IT ISN'T EARNED THROUGH COMMODITY EXPORTS OR TOURISM, SEND IT ABROAD WITH SIGNIFICANTLY FEWER RESTRICTIONS THAN IN PAST.

4. IN CONCLUSION IF GOE DEVALUED THE POUND TO .80/US\$. OFFERED 8 PER CENT INTEREST ON FX DENOMINATED SAVINGS DEPOSITS, 15 LIMITED OFFICIAL USE

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PAGE 03 CAIRO 17463 171948Z

PERCENT INTEREST ON EGYPTIAN POUND DENOMINATED DEPOSITS, AND ENCOURAGED THE PRIVATE SECTOR, THERE WOULD BE LITTLE REASON TO WORRY ABOUT FREE CONVERTIBILITY -- INDEED IT WOULD BE AN EXERCISE CENTERED ON ALL TIME DEPOSITS, AND UNCERTAIN PROGRESS ON ENCOURAGING THE PRIVATE SECTOR IN PROSPECT, FREER CONVERTIBILITY IS WORRISOME. HOW WORRISOME IS DEPENDENT ON THE AS YET UNKNOWN DETAILS OF THE APPLICABLE REGULATIONS AND PROGRESS BY GOE IN IMPLEMENTING RELEVANT EVEN REFORMS.

DECON 1/1/78.

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